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# INVESTMENT SECTION

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for Fiscal Year ending June 30, 2008

## **REPORT ON INVESTMENT ACTIVITY**

This report is prepared by the Investment staff of the  
Kentucky Teachers' Retirement System.

**Mr. Paul L. Yancey, CFA**  
Chief Investment Officer

**Mr. Philip L. Webb**  
Director of Investment Accounting

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## **INVESTMENT COMMITTEE**

**Mr. Robert M. Conley**  
*Chairman*

**Mr. Ronald L. Sanders**  
*Vice-Chairman*

**Mr. Gary L. Harbin, CPA**  
*Member*

## **EXECUTIVE INVESTMENT STAFF**

**Mr. Gary L. Harbin, CPA**  
*Executive Secretary*

**Mr. Paul L. Yancey, CFA**  
*Chief Investment Officer*

**Becker, Burke Associates**  
**Incorporated**

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Chicago, Illinois 60601  
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October 10, 2008

Mr. Paul Yancey  
Chief Investment Officer  
Kentucky Teachers' Retirement System  
477 Versailles Road  
Frankfort, KY 40601

Dear Mr. Yancey:

Becker, Burke Associates served as Investment Consultant to the Kentucky Teachers' Retirement System during the 2007-08 fiscal year, as it has in several previous years. Becker, Burke Associates is familiar with the operation of the System's investment program as well as its performance. The investment program of the Retirement System is operated in a prudent manner that reflects a desire to preserve capital while optimizing the reward/risk characteristics. The assets of the Retirement System are assigned to various investment managers in order to diversify the System's investments and take advantage of opportunities in numerous asset classes and sectors.

During the fiscal year, the System continued to make progress toward its goal of further diversifying the assets in order to enhance the expected reward/risk characteristics of the Plan. The System increased its exposure to international equity, small and mid-cap equity, real estate, and alternative investments. Going forward, the shift in asset allocation will continue to progress in a consistent and prudent manner. This will ensure that sound decisions are being made and will limit the risk of poor timing.

Very truly yours,



Howard H. Pohl  
President, Becker, Burke Associates

## **INVESTMENT POLICY SUMMARY**

The KTRS Board of Trustees has a statutory obligation to invest the members' assets in a manner consistent with the fiduciary standards set forth in the "prudent person rule." Consistent with these fiduciary standards, the board has recognized certain principals that guide investment-related decisions. First, the board will preserve the long-term corpus of the fund. Second, the board will seek to maximize total investment return within prudent risk parameters. Third, the board will act in the exclusive interest of the members and beneficiaries of the System. This broad summary is a reference point for management of System assets and outlines KTRS' investment philosophy and practice.

## **INVESTMENT OBJECTIVES**

KTRS invests the members' funds in several diverse classes of assets, including equities, bonds and real estate. This diversification helps us earn the highest possible long-term rate of return within appropriate risk levels. In turn, this enables us to pay guaranteed benefits to members and their beneficiaries at the lowest possible cost to participating employers and the taxpayers that fund them.

Generally, the System's liabilities will not be paid for as many as 30-40 years. Therefore, as a long-term investor, KTRS holdings can withstand some short-term volatility. The System's long-term investment objective is to achieve an annualized rate of return of 7.5%. For the twenty year period ended June 30, 2008, the System's annualized return was 8.6%, well ahead of the long-term investment objective.

## **RISK CONTROLS**

The KTRS investment program faces numerous risks; however, the primary risk to KTRS is that the assets will not support liabilities over long periods of time. In order to control this risk and numerous other risks, the board has taken the following steps, on an ongoing basis, to help control risk:

- Actuarial valuations are performed each year to evaluate the funding objectives of the System. In addition, every ten years an external audit of the actuary is conducted to ensure that the assumptions made and calculation methods used are resulting in properly computed liabilities of the System.
- Asset/liability studies are conducted, at a minimum, every five years. These studies ensure that the portfolio design is structured to meet the liabilities of the System.
- The KTRS investment committee adopts, and regularly reviews, detailed investment strategies for implementation of the investment policy.

### ASSET ALLOCATION

The System undertakes asset/liability studies every five years. In addition, the System's investment consultant, on an annual basis, presents to the Investment Committee target percentages and ranges for the System's various asset classes. Annually approved asset allocation parameters serve to balance the System's liquidity requirements, volatility tolerance, and return requirements to meet both short-term and long-term obligations. The System's assets are diversified across a variety of asset classes, investment management styles, and individual securities in order to reduce volatility and enhance the potential of the investment portfolio to achieve the System's long-term goals.

Asset allocation decisions for pension plans are highly dependent on the unique characteristics of a particular plan. Factors such as fixed employer contributions, the non-participation of members in Social Security, liability requirements, level of funding, and statutory investment restrictions are important considerations within the context of the asset allocation decision making process. Consequently, asset allocation comparisons between various pension plans may be quite different.

The following information reflects the System's asset allocation by market value as of June 30, 2008, and June 30, 2007, as well as the target and strategic range for each asset class for Fiscal Year 2008.

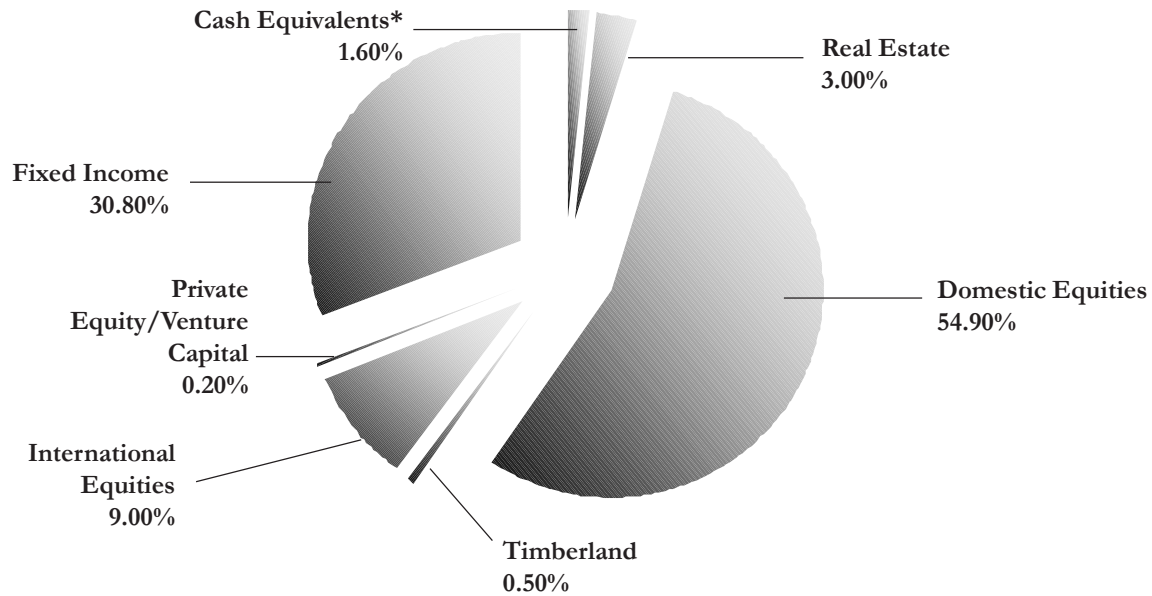
	<u><b>6-30-2008</b></u>	<u><b>%</b></u>	<u><b>6-30-2007</b></u>	<u><b>%</b></u>
Cash Equivalents *	\$ 221,260,264	1.6	\$ 454,641,986	2.9
Fixed Income **	4,381,342,566	30.8	4,523,620,912	29.1
Domestic Equities	7,815,837,500	54.9	9,133,172,818	58.8
International Equities	1,278,613,411	9.0	1,039,849,210	6.7
Real Estate	431,693,774	3.0	381,693,796	2.5
Private Equity	28,791,613	0.2	5,074,147	0.0
Timberland	75,995,962	0.5	-0-	0.0
Totals	<u><u>\$ 14,233,535,090</u></u>	<u><u>100.0</u></u>	<u><u>\$ 15,538,052,869</u></u>	<u><u>100.0</u></u>

\* Reflects only cash balances not allocated to other asset classes. Uninvested cash balances allocated to various asset classes are represented in the respective asset classes.

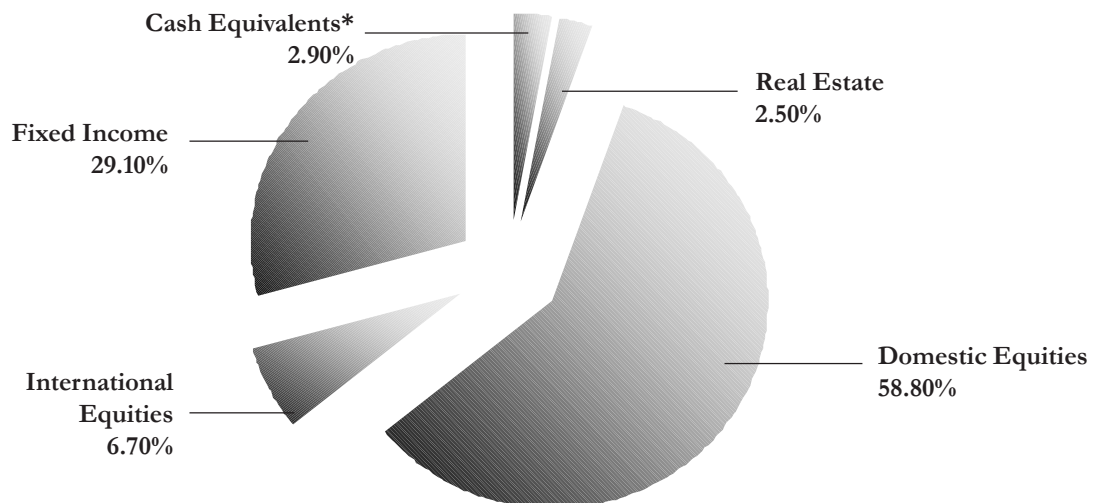
\*\* Excludes purchased interest of \$273,868 as of June 30, 2008.

## Distribution of Investments Market Values

June 30, 2008



June 30, 2007



\* Reflects only cash balances not allocated to other asset classes. Uninvested cash balances allocated to various asset classes are represented in the respective asset classes.

## INVESTMENT SECTION

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<b>Asset Class</b>	<b>Regulatory Limits (Mkt Value)</b>	<b>Strategic Range (Mkt)</b>	<b>Target (Mkt)</b>	<b>6/30/2008 (Mkt)</b>
<b>Cash</b>		1-4%	1.0%	1.6%
<b>Fixed Income</b>		25-32	28.0	30.8
<b>Government/Agency/Other</b>	Unlimited			17.6
<b>Corporate</b>	35%			13.2
<b>Equity</b>	65%	50 - 65	65.0	63.9
<b>Domestic Large Cap</b>		40 - 50	49.0	48.1
<b>Domestic Mid/Small Cap</b>		5 - 10	7.0	6.8
<b>International</b>		5 - 10	9.0	9.0
<b>Real Estate</b>	10%	2 - 5	4.0	3.0
<b>Alternative Investments*</b>	10%	0 - 2	2.0	0.7
<b>Additional Categories</b>	10%		<u>0.0</u>	<u>0.0</u>
<b>TOTAL</b>			<b>100.0%</b>	<b>100.0%</b>
This weighting reflects cash with manager in the manager's asset class.				
* Alternative Investments includes Private Equity, Timberland, Venture Capital and Infrastructure investments.				

## PORTFOLIO RETURNS

The System's portfolio generated a total return of -5.7% for the fiscal year ended June 30, 2008 in a difficult and volatile period in the financial markets. Domestic equities returned -12.5% versus -12.7% for the Standard & Poor's (S&P) 1500, while fixed income returns matched those of the Lehman Government/Credit Index at 7.2%. International equities returned -11.3% versus -10.2% for the MSCI EAFE Index. For one, five, ten, and twenty year periods ended June 30, 2008, the portfolio's domestic equity and fixed income components have matched or exceeded their benchmarks. For the twenty-year period ended June 30, 2008, the total fund's annualized return was 8.6%, well ahead of the actuarial assumed rate of return of 7.5%. The System's returns were generated by the Rogers Casey performance reporting system using a time-weighted rate of return calculation based upon the modified Dietz methodology. The table below outlines historical performance for the total fund and its component asset classes.

	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>	<u>20 Yr</u>
KTRS Total Fund	-5.7	4.7	6.2	4.6	8.6
Allocation Index*	-5.9	4.8	6.0	4.8	8.2
Total Domestic Equity	-12.5	4.5	8.0	3.6	11.1
S&P Blended Index **	-12.7	4.6	7.7	2.9	10.5
Total International Equity	-11.3	—.-	—.-	—.-	—.-
MSCI EAFE	-10.2	—.-	—.-	—.-	—.-
Total Fixed Income	7.2	4.0	3.8	5.8	7.5
Lehman Government/ Credit Index	7.2	3.8	3.6	5.7	7.4
Real Estate Equity	7.8	9.1	9.3	9.1	8.6
CPI plus 2%	6.9	5.9	5.5	5.0	5.2
Short Term Investments	4.1	5.4	3.9	4.0	5.1
90 day Treasury Bill	3.6	4.2	3.1	3.6	4.4

\* The Allocation Index is based on the System's asset class breakdown for each of the last 20 years.

All stock allocations are benchmarked to the S&P 500.

All fixed income allocations are benchmarked to the Lehman Government/Credit Index.

All Short Term allocations are benchmarked to the 90 day Treasury Bill.

All Real Estate allocations are benchmarked to the CPI plus 2%.

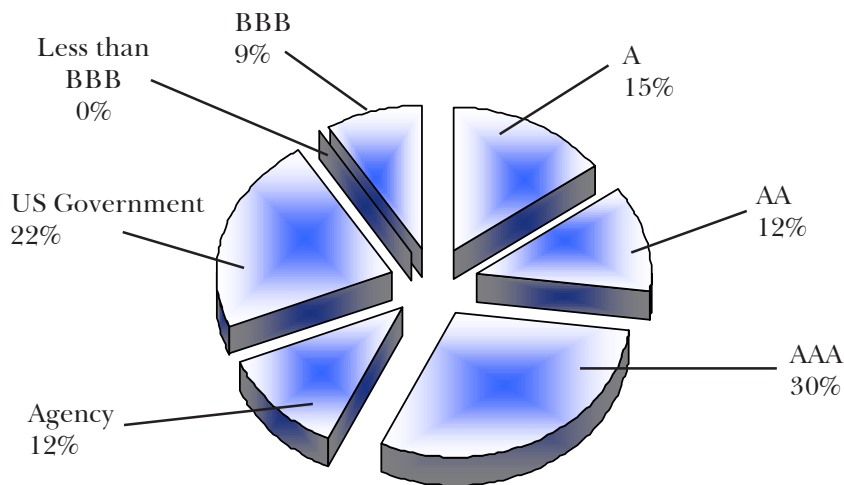
\*\* Total Domestic Equity through the fiscal year ending 6/30/07 was benchmarked to the S&P 500. As of 7/01/08 the domestic stock mix is most comparable to the S&P 1500 index. The S&P Blended Index is made up of S&P 500 returns through fiscal year ending 6/30/07 and the S&P 1500 returns for the last fiscal year.



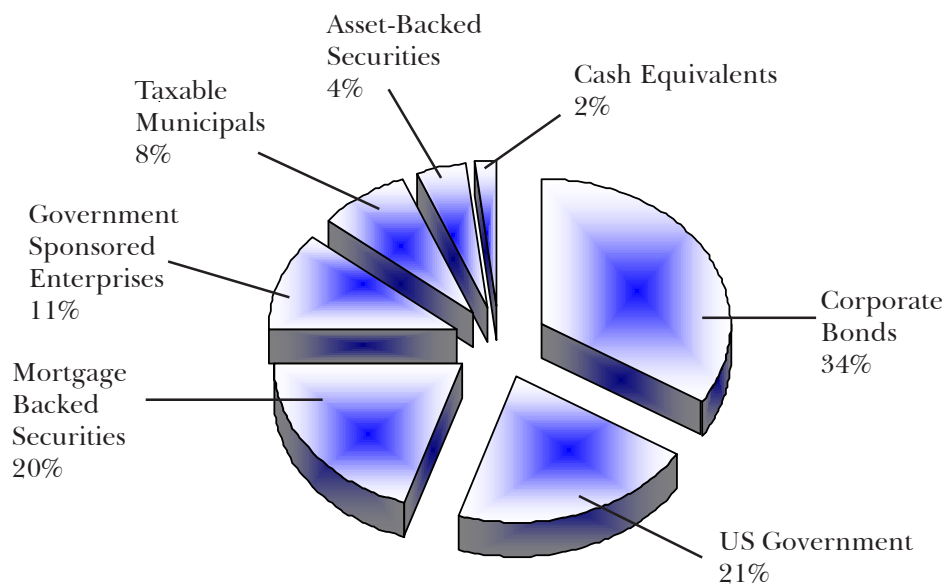
### FIXED INCOME INVESTMENTS

As of June 30, 2008, the System had approximately \$4.4 billion in fixed income assets, or 30.8% of total assets. Over \$2.5 billion was managed internally with the remainder, or about \$1.84 billion, managed by two external managers. The System's investment policy established by administrative regulation requires that all fixed income investments be rated investment grade at the time of purchase by one of the major rating agencies. The regulation further requires that the fixed income portfolio as a whole maintain an average rating equal to at least "AA" by one of the major rating agencies.

### FIXED INCOME QUALITY DISTRIBUTION



### FIXED INCOME SECTOR DISTRIBUTION



## **FIXED INCOME MARKET OVERVIEW**

The credit markets remained in turmoil throughout the fiscal year. A collapse in the subprime mortgage market and related investment vehicles led to massive writedowns and a crisis of confidence throughout the financial system beginning in the summer of 2007, which threatened the vital flow of liquidity. Interbank lending rates rose dramatically as did yields on all but U.S. government debt, as liquidity threatened to grind to a halt.

The Federal Reserve responded aggressively, taking various unconventional actions to restore liquidity and confidence, including opening its discount window lending facility to nonbank financial institutions. The Fed also made seven progressive moves, lowering the federal funds rate from 5.25% in September, 2007 to 2.00% on April 30, 2008. Despite all this, investment bank Bear Stearns suffered a liquidity crisis in March, 2008 and was forced into a Fed-assisted takeover by J.P. Morgan.

Through the middle of 2008, the credit crisis showed no signs of abating. The underlying housing downturn persisted. As of June, 2008, home prices nationally had declined 18% from their peak in June 2006, according to the S&P/Case-Shiller Index. Delinquencies and foreclosures were soaring even on prime mortgages. An alarming inventory of unsold homes portended further declines in prices.

The problems went beyond housing, however, as the tightness of credit itself was exacerbating underlying economic weakness and threatening a more generalized downward spiral of credit deterioration. Non-farm payrolls steadily declined through the first half of 2008 and the unemployment rate crept up to 5.5% in June, 2008 from a low of 4.4% in March, 2007. Oil prices rose from about \$70 per barrel at the end of June, 2007 to \$140 on June 30, 2008, putting further stress on the consumer.

This environment led to an extraordinary surge in volatility in the fixed income markets as well as extreme divergences in the relative performance of various sectors. In general, there was a flight to the safety of U.S. Treasuries, producing higher prices and lower yields. The reverse was true in many other sectors, however, as risk aversion was the driving force. Broad indices which carry heavy weightings of U.S. Treasury securities produced solid returns. The Lehman Government/Credit Index returned 7.24% for the fiscal year. Below the surface, the divergences were remarkable. U.S. Treasuries returned 10.33% while investment grade corporate bonds overall returned only 2.95%. Investment grade financial institution bonds returned only 0.65%. Asset-backed securities returned -2.08%, below investment grade corporates overall returned -2.26%, and below investment grade financial institutions returned -17.10%. Agency-backed mortgages performed relatively well, returning 7.92%

As the fiscal year came to an end, the credit markets and financial system overall remained under stress. Economic conditions were weak both domestically and globally. The Fed appeared unlikely to raise short term rates in the foreseeable future. Inflation concerns, driven primarily by energy and other commodity prices, appeared to be receding. The good news was that the turmoil had driven yield premiums over safe Treasury securities quite high, even for high quality fixed income securities. There were opportunities for patient investors. Caution remained in order, however, as market turmoil and continued credit deterioration remained a concern.

## EQUITY INVESTMENTS

The System's public equity investments had a market value of \$9.1 billion as of June 30, 2008, representing 63.9% of total assets. Public equities remained close to the 65% target throughout the fiscal year. The System divides its public equity investments into two broad categories: domestic and international.

The domestic portfolio had a market value of \$7.8 billion as of June 30, representing 54.9% of total assets. The domestic portfolio is benchmarked to the S&P 1500 Index. The S&P 1500 is composed of three well-known component indices based upon capitalization: the large cap S&P 500, the mid cap S&P 400, and the small cap S&P 600. The System's domestic equity holdings are divided into eleven portfolios. Three are internally managed index funds benchmarked to the S&P 500, S&P 400, and S&P 600, respectively. Eight other portfolios are externally managed, with each representing a specific capitalization universe and style or strategy; each is compared to an appropriate benchmark. The collective array of portfolios provides diversification by capitalization, manager, style, and strategy.

International equity holdings had a market value of \$1.3 billion as of June 30, representing 9.0% of total assets. International equities are benchmarked against the Morgan Stanley Capital International (MSCI) EAFE (Europe, Australasia, Far East) Index, which represents the markets of twenty-one developed countries. The System's international equity holdings are managed by four external managers. Through much of the fiscal year, the percentage of total assets invested in international equity was 7.5%. In early May, two new international managers, Baillie Gifford and Baring Asset Management, were hired, bringing the international exposure up to the 9.0% level. It is expected that the level of investment in international equity will continue to increase during the coming fiscal year. While international equity holdings are benchmarked against the EAFE Index, which includes only developed country equities, the individual managers are allowed strategic exposure to emerging markets on a limited basis.

## EQUITY MARKET OVERVIEW

The fiscal year was a difficult one for equity investors. Equity markets all over the world suffered as the MSCI World Index declined -10.2%. The domestic market fared a bit worse, as the S&P 1500 fell -12.7%. International developed markets, as measured by the MSCI EAFE Index, had a decline of -10.2%. Emerging markets, however, bucked the trend as the MSCI Emerging Markets Index rose 4.9%. This marked the fifth straight fiscal year that international equity returns, as measured by the EAFE Index, have exceeded domestic S&P 1500 returns.

Domestic stocks suffered their first decline in several years as the fallout from a weak housing market and associated mortgages forced large financial institutions to take huge writedowns related to mortgage securities. This led to the stunning collapse of Bear Stearns and its acquisition by J.P. Morgan in March. The damage was not limited to domestic financial institutions as many large international institutions also held securitized securities backed by assets in the U.S. Rising energy prices were largely attributed to increased incremental demand from China and India coupled with OPEC's inability to increase supply. Demand from India and China was also blamed for generally higher commodity prices, especially metal prices. The Commodities Research Bureau (CRB) Index, a broad measure of commodities prices, rose 47% over the fiscal year. The combination of falling home prices and rising energy costs led to a drop in consumer confidence and pressured consumer spending. The University of Michigan's Consumer Sentiment Index fell to its lowest level in almost thirty years. Toward the end of the fiscal year, many investors worried

about inflation as commodity prices continued to remain high, the dollar reached new lows, and the Federal Reserve had aggressively cut rates to bolster the financial system.

Within the capitalization segments of the S&P 1500, the mid cap S&P 400 was the best performer with a decline of -7.3% compared with the large cap S&P 500 return of -13.1% and the small cap S&P 600 at -14.7%. For the past five years, the returns of small and mid cap domestic stocks have exceeded those of the larger cap stocks in the S&P 500. This past year, growth stocks within the S&P 500 outperformed value stocks by over 10%. This marked the first time in the last five years that growth stocks have registered better returns than those of value stocks. Sector allocation was a far more important determinant of the relative performance of various indices and portfolios over the fiscal year than capitalization or style. Within the S&P 1500, the energy sector had a positive return of 27.6%, while the financial sector had a decline of -41.0%.

The domestic market peaked in October, 2007, and began a five month decline into the following March as the combination of higher energy prices and credit market woes continued to plague the market. The market reached a climactic bottom in March when Bear Stearns collapsed. After the Bear Stearns collapse, the market rallied into mid-May as investors believed that the worst of the financial institutions' problems were past. The S&P 1500 suffered a 10% drop from the middle of May to the end of June as oil prices rose and financial institutions continued to write down assets and raise capital.

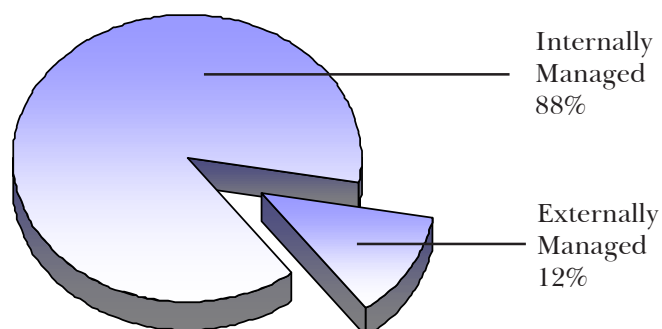
The international equity markets were affected by several of the same factors affecting the domestic markets, namely higher energy prices and asset writedowns at large financial institutions. The pattern of returns for the EAFE Index closely mirrored that of the domestic market. The course was somewhat different, however, for emerging markets. The MSCI Emerging Markets Index, made up of twenty-five less developed countries, returned 4.9% for the fiscal year. Over the past five years, the emerging markets have produced an annualized return of 30.2% versus 17.2% for the developed markets EAFE Index. The emerging markets offer additional diversification benefits, as they are not as correlated with the domestic equity market as the EAFE, but they are more volatile due to less developed economies and are subject to more political instability.

## REAL ESTATE

The System's real estate investments had a market value of \$431.7 million as of June 30, 2008, representing 3.0% of total assets. The System's investments in real estate are intended to provide attractive long-term returns, generate reliable cash flow, and provide diversification, thereby reducing the volatility of the overall investment portfolio.

The System's real estate exposure is currently provided through two portfolios. The System maintains an internally managed portfolio of directly owned properties under long-term lease agreements with high credit quality tenants. The System is also invested in a commingled real estate fund (PRISA Fund), which is managed by Prudential Real Estate Investors. This Fund is a core real estate equity fund which invests primarily in existing income-producing properties with strong cash flow and the potential for capital appreciation. The Fund is diversified across several property types including office, retail, industrial, apartment, self-storage, and hotel.

**Real Estate Investments**  
**June 30, 2008**  
**\$431.7 Million Market Value**



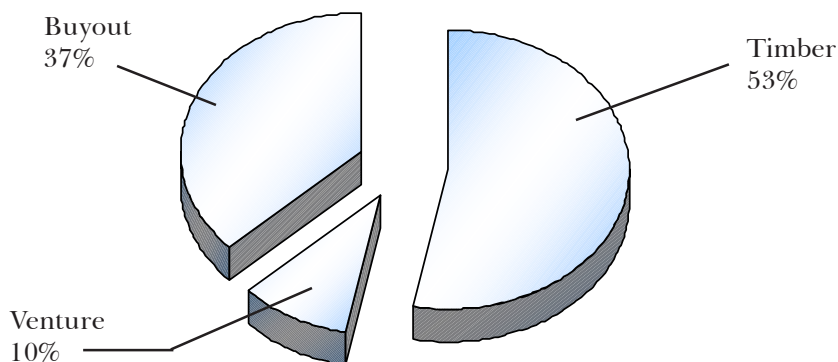
**REAL ESTATE OVERVIEW**

During the fiscal year, the softening economy and turbulence in the broader capital markets took a toll on commercial real estate markets nationally. Generally, most markets experienced slower leasing activity, declining occupancy levels, and downward pressure on rents. Many economists are predicting continued weakness in the real estate market going into 2009. This slowdown in the real estate market may well provide an opportunity for investors as property prices come down from the historic highs of recent years. The System will look for opportunities to strategically increase commercial real estate exposure over the next 12 to 24 months.

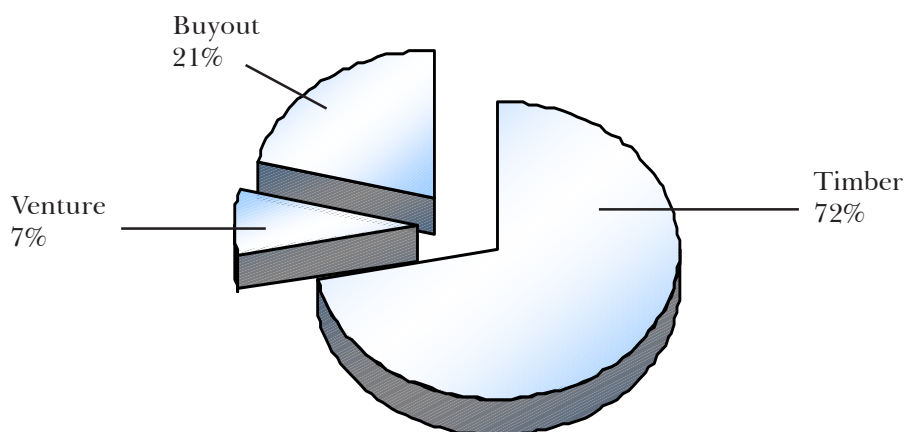
**ALTERNATIVE ASSETS**

As of June 30, 2008, the System had committed \$375 million to alternative investments and had funded \$106 million of those commitments. The percentage of the System's portfolio in alternative assets was 0.7%. The System's current alternative assets portfolio consists of private equity investments (both venture capital and buyout) and timberland.

**Alternative Assets Committed**  
**\$375 Million as of June 30, 2008**



**Alternative Assets Funded  
\$106 Million as of June 30, 2008**



### **PRIVATE EQUITY**

The System has gained exposure to both venture capital and buyouts via direct participation in limited partnerships as well as investment in a fund of funds. The System is in the initial stages of its private equity investment program, which it intends to grow with a disciplined plan of commitments over the next several years. The System looks to diversify its private equity portfolio by firm, country, strategy, and vintage year. The System will achieve vintage year diversification by building out the portfolio with disciplined levels of commitment over time. The System's commitment to any given partnership shall not exceed 20% of that partnership's total commitments.

The Board and the staff understand that private equity (along with many other forms of alternative assets) are illiquid and have a long-term holding period. When added to a portfolio with other publicly traded assets, this asset class can help to diversify and reduce risk for the System's overall portfolio while enhancing returns. Private equity returns for the first several years of a partnership's life are routinely negative due to the J-curve effect. Positive returns are typically realized only several years into a partnership's existence.

### **PRIVATE EQUITY MARKET OVERVIEW**

The boom in private equity buyouts evaporated beginning in the summer of 2007 as financing for deals dried up with the onslaught of the credit crunch. By the summer of 2008, the credit crisis had only intensified and the drought of deal-making continued. Venture firms, meanwhile, were more focused on keeping their businesses afloat as economic growth stagnated, particularly in the industrialized world. However, the most nimble private equity firms were finding opportunities in this environment as many institutions were raising capital through the liquidation of assets at significantly reduced prices. As financial conditions around the world begin to recover, the expectation would be to see more private equity transactions, although with less leverage than in the past.

## **TIMBERLAND**

In addition to private equity, the System has invested in timberland in the alternative asset classification. As of June 30, 2008, the System owned approximately 68,000 acres of timberland. Timberland is, by nature, a long term investment as our anticipated time horizon in this asset category is generally a minimum of ten to fifteen years. Timberland provides valuable diversification, current income, and a hedge against inflation. Due to the low correlation of returns with other asset classes, timberland investments should lower the overall volatility of the System's portfolio. Timberland should earn real returns comparable to traditional equity investments with volatility between equities and fixed income over the long-term.

The System diversifies its timberland investments by geography, species of trees, and maturity of timber stands. Investment returns from timberland are primarily derived from net cash flow generated from the sale of trees (referred to as stumpage sales) and capital appreciation from the biological growth of the trees. Both of these return factors depend to some degree upon the direction of forest commodity prices (paper goods and lumber products). There can also be gains from the timely sale of timberland and from the conversion of timberland into higher and better uses, such as vacation property sales.

## **TIMBER MARKET OVERVIEW**

Increases in the US population, income, and economic activity have been strong forces in the growth of demand for timber products. Recently however, the deteriorating US housing market and overall weak US economy have served to dampen demand, putting downward pressure on timber prices. Over the next five to ten years, a shrinking supply of timber from the southern US due to suburbanization, increased demand due to a recovering housing sector, and the growth of wood as an energy source are expected to put upward pressure on timber prices.

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KENTUCKY TEACHERS' RETIREMENT SYSTEM

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**PORTFOLIOS**  
**MARKET VALUES \*\***  
**June 30, 2008**

**Internally Managed**

**Cash Equivalents**

Cash Collections Fund	\$ 221,260,264
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**Fixed Income \***

Broad Market Bond Fund	1,115,677,243
Long Term Bond Fund	635,645,904
Intermediate Bond Fund	490,318,668
Internal Bond Fund	220,257,298
Life Insurance Trust (Retired)	74,411,759
Life Insurance Trust (Active)	1,849,400
Tax Shelter Fund	499,048
Scholarship Fund	487,255

**Equity**

S&P 500 Index Fund (Large Cap)	2,931,555,579
S&P 400 Index Fund (Mid Cap)	335,002,746
S&P 600 Index Fund (Small Cap)	236,929,479

**Real Estate**

Internally Managed Fund	381,693,775
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**Subtotal**

**6,645,588,418**

**Externally Managed**

**Fixed Income**

Galliard Capital Management	864,895,117
Ft. Washington Broad Market	748,040,818
Ft. Washington Bond Index Plus	229,260,056

**Domestic Equity:**

Todd Investment Advisors (Large Cap Core)	1,517,820,961
UBS (Large Cap Value)	1,049,211,913
GE Asset Mgmt. (Large Cap Growth)	645,725,658
Wellington (Large Cap Core)	557,192,302
Wellington (Mid Cap Core)	261,154,364
Wellington (Small Cap Core)	132,405,825
UBS (130/30)	102,998,957
Todd Opportunity Fund	45,839,716

**International Equity:**

Todd International	507,654,384
UBS International	488,863,416
Baring Focused International Equity	143,997,345
Baillie Gifford EAFE Alpha	138,098,265

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## INVESTMENT SECTION

### **PORTFOLIOS (CONTINUED) JUNE 30, 2008**

**Real Estate:**

Prudential PRISA Fund	\$	50,000,000
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**Alternative Investments**

Molpus Woodlands Group		
Lake Superior Timberlands LLC		75,995,962
KKR 2006 Fund		17,950,175
Chrysalis Venture Fund III		5,197,590
Fort Washington Private Equity Fund V		3,399,859
KKR European Fund III		2,243,989

<b>Subtotal</b>		<b>7,587,946,672</b>
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<b>Total Assets</b>	<b>\$</b>	<b>14,233,535,090</b>
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\* Excludes purchased interest of \$273,868 as of June 30, 2008.

\*\* Detailed information concerning these market values of all KTRS investments is available upon request.

### **Investment Summary Fair Market Value 06/30/2008**

Type of Investment	Fair Value 07/01/07	Acquisitions	Appreciation (Depreciation)	Sales Redemptions, Maturities & Paydowns	Fair Value 06/30/08
Cash Equivalents	\$ 566,457,900	\$ 34,570,107,000	\$ 8,107,600	\$ 34,755,900,000	\$ 388,772,500
Fixed Income	4,470,207,000	1,714,491,300	91,998,500	1,997,522,600	4,279,174,200
Equities	10,114,620,000	2,886,215,100	(1,431,996,400)	2,539,457,900	9,029,380,800
Real Estate	381,693,800	50,000,000	0	0	431,693,800
Alternative	5,074,200	102,207,500	(1,227,900)	1,266,200	104,787,600
<b>TOTAL</b>	<b>\$ 15,538,052,900</b>	<b>\$ 39,323,020,900</b>	<b>\$ (1,333,118,200)</b>	<b>\$ 39,294,146,700</b>	<b>\$ 14,233,808,900</b>

# KENTUCKY TEACHERS' RETIREMENT SYSTEM

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## Contracted Investment Management Expenses

**Fiscal Year 2007-08**  
*(in thousands of dollars)*

<u>Investment Manager Fees</u>	<u>Assets Under Management</u>	<u>Expense</u>	<u>Basis Points (1)</u>
Fixed Income Manager(s)	\$ 864,895	\$ 384	
Equity Manager(s)	3,519,648	6,801	
Balanced Manager	3,048,616	1,375	
Private Equity Fees (2)	104,788	1,084	
Total	\$ 7,537,947	\$ 9,644	12.8
 <u>Other Investment Services</u>			
Custodian Services	\$ 14,233,535	\$ 548	0.4
Investment Consultant		65	
Legal & Research Fees		37	
Total		650	
<b>Grand Total</b>		<b>\$ 10,294</b>	<b>7.2</b>

1 – One basis point is one hundredth of one percent or the equivalent of .0001.

2 – Private equity fees are either withheld from the Fund operations or paid by direct disbursement, depending on contract terms. This schedule includes fees withheld from fund operations.

## Transaction Commissions

Fiscal Year 2007-08

COMPANIES	SHARES TRADED	COMMISSIONS	COMMISSION PER SHARE
AG Edwards	5,000	200.00	0.0400
B Trade Services	6,900	34.50	0.0050
Bank of America	275,430	11,526.70	0.0418
Bass Trading	33,400	774.00	0.0232
Bear Stearns & Co Inc	182,560	7,629.50	0.0418
Blair William & Co	2,000	80.00	0.0400
BMO Capital Markets	2,500	125.00	0.0500
BNY Brokerage / LJR	2,442,300	97,692.00	0.0400
Boenning & Scattergood	159,000	3,577.50	0.0225
Canacord Adams	50,400	2,016.00	0.0400
Cantor Fitzgerald & Co	97,600	3,859.00	0.0395
CIBC Oppenheimer Worldmarket	30,570	4,260.80	0.1394
Citigroup Global	1,510,116	70,038.56	0.0464
Citigroup-Huntington	4,047,700	161,908.00	0.0400
Citigroup-Louisville	4,080,455	163,218.20	0.0400
Cowen & Co	71,200	2,848.00	0.0400
Credit Suisse Sec LLC	2,801,901	111,050.42	0.0396
Crowell Weedon & Co	52,011	2,080.44	0.0400
Deutsche Bank	100,700	7,254.40	0.0720
Fidelity Capital Markets	9,800	286.50	0.0292
First Kentucky Securities Corp	3,249,729	129,989.16	0.0400
Fox Pitt Kelton Inc	16,000	640.00	0.0400
Freidman Billings	126,645	3,563.80	0.0281
FTN Financial	5,500	220.00	0.0400
Goldman Sachs	5,367,884	180,430.71	0.0336
Heflin & Co	60,600	2,279.00	0.0376
Howe Barnes Investment	12,475	499.00	0.0400
Imperial Capital	21,000	840.00	0.0400
Instinet	51,800	1,056.75	0.0204
Investment Tech Grp Transition	3,178,000	23,835.03	0.0075
Investment Technology Grp	33,409,132	587,764.05	0.0176
ISI Group	4,075,700	163,028.00	0.0400
Jefferies & Co	3,763,359	148,399.61	0.0394
JJB Hilliard WL Lyons	3,965,100	158,604.00	0.0400
JMP Securities	33,800	1,047.00	0.0310
Jones & Associates	38,210	1,528.40	0.0400
JP Morgan & Chase	126,600	13,969.62	0.1103
Keefe Bruyette & Woods	14,488	624.52	0.0431
Knight Equity Markets	159,369	5,166.06	0.0324
Lazard Freres & Co	5,727,900	229,116.00	0.0400
Lehman Brothers	5,214,076	227,438.16	0.0436
Lexington Investment Co	1,569,012	62,760.48	0.0400
Liquidnet Inc	1,962,143	38,147.86	0.0194
Merrill Lynch	8,233,638	198,511.85	0.0241

# KENTUCKY TEACHERS' RETIREMENT SYSTEM

## *Transaction Commissions continued . . .*

COMPANIES	SHARES TRADED	COMMISSIONS	COMMISSION PER SHARE
Morgan Keegan	3,173,800	126,952.00	0.0400
Morgan Stanley	6,546,293	242,841.69	0.0371
Murphy & Durieu	30,400	684.00	0.0225
Needham	8,700	348.00	0.0400
OTA Limited Partners	1,800	72.00	0.0400
Pipeline Trading	1,100	16.50	0.0150
Piper Jaffray	31,400	2,330.00	0.0742
Pulse Trading	33,950	763.88	0.0225
R W Baird	84,375	3,375.00	0.0400
Raymond James & Assoc	6,528,850	261,191.25	0.0400
RBC Capital Markets	11,600	464.00	0.0400
Robbins & Henderson	4,300	96.75	0.0225
Ross Sinclair & Assoc	2,422,200	96,888.00	0.0400
Sandler O'Neill	44,600	1,784.00	0.0400
Sanford C Bernstein	22,300	367.00	0.0165
SG Cowen	3,900	156.00	0.0400
Source Trading	26,500	596.25	0.0225
State Street Global	93,300	2,799.00	0.0300
Sterne Agee & Leach	5,300	212.00	0.0400
Stifel Nicolaus & Co	3,151,200	126,048.00	0.0400
Suntrust Robinson	4,000	160.00	0.0400
Thomas Weisel Partners	17,000	703.00	0.0414
UBS/Paine Webber Securities	5,721,857	104,092.33	0.0182
UBS/Paine Webber-Louisville	7,186,800	287,472.00	0.0400
Wachovia / First Clearing Corp	193,835	7,753.40	0.0400
Wedbush Morgan Securities	2,200	88.00	0.0400
Weeden & Co	4,068,716	162,748.64	0.0400
<b>Grand Total</b>	<b>135,763,979</b>	<b>4,260,921.27</b>	<b>0.0314</b>

The over-the-counter commission rate on medium to large capitalization stocks is assumed to be \$.04 per share. The acquisition of initial public offerings (IPOs) represented a portion of small capitalization stock purchases. IPOs usually have a high commission rate. However, the security issuers and not the investors pay the commissions. In 2007-08, the System bought small capitalization IPOs that generated \$122,317.53 in commissions. Although these commissions were not paid by the Retirement System, they resulted from the System's investment activities and are included in the total commissions of \$4,260,921.27. Typical stock transactions occur at lower commission rates than IPO transactions, frequently \$.03 per share or less. Investment companies usually provide investment research for brokerage clients. On occasion, investment companies direct third party research to active clients. The Retirement System received third party research through Lynch Jones Ryan, Merrill Lynch and Lehman Brothers. Trading commissions of \$97,692.00 were associated with third party research obligations. The primary research providers were: Bloomberg, Interactive Data, Rogers Casey, RiskMetrics Group, QED Financial Systems, and Thomson Financial.

**Ten Largest Stock Holdings Ranked (1) (2)  
by Market Value  
06/30/08**

<u>Rank</u>	<u>Name</u>	<u>Market Value</u>	<u>Percentage of Equities</u>
1	Microsoft	168,279,825	2.062
2	Exxon Mobil Corp	148,957,326	1.825
3	General Electric	127,243,881	1.559
4	Chevron Corp	121,034,459	1.483
5	A T & T	108,320,122	1.327
6	ConocoPhillips	103,125,039	1.263
7	Intel Corp	99,282,708	1.216
8	Cisco Systems Inc	95,772,655	1.173
9	Qualcomm Inc	94,839,544	1.162
10	AFLAC Inc	87,262,672	1.069

**Top Ten Fixed Income Holdings (2)  
by Market Value  
06/30/08**

<u>Rank</u>	<u>Description</u>	<u>Maturity</u>	<u>Coupon</u>	<u>Par</u>	<u>Market Value</u>	<u>Percent of Fixed Income</u>
1	U S Treasury Bonds	08/15/23	6.250	102,000,000.00	121,356,540.00	2.836
2	U S Treasury Notes	04/30/12	4.500	75,555,000.00	79,202,795.40	1.851
3	U S Treasury Notes	05/15/15	4.125	53,000,000.00	54,768,080.00	1.280
4	FNMA Notes	11/15/21	5.625	54,000,000.00	54,759,240.00	1.280
5	U S Treasury Bonds	02/15/21	7.875	33,500,000.00	44,664,880.00	1.044
6	U S Treasury Bonds	08/15/21	8.125	29,815,000.00	40,732,358.55	0.952
7	U S Treasury Bonds	08/15/29	6.125	30,000,000.00	36,185,100.00	0.846
8	U S Treasury Bonds	11/15/26	6.500	29,000,000.00	35,848,930.00	0.838
9	U S Treasury Bonds	05/15/16	7.250	27,500,000.00	33,788,425.00	0.790
10	FNMA Notes	01/15/30	7.125	25,000,000.00	31,172,000.00	0.729

(1) Includes only actively managed separate accounts

(2) Detailed information concerning these values along with book values and cost values of all KTRS investments is available upon request.

## PROXY VOTING AND CORPORATE BEHAVIOR

The System regularly votes proxy statements associated with its equity ownership. The positions assumed by the System are intended to represent the financial interests of the membership. The Board of Trustees has adopted a policy that directs the staff not to subjugate the financial concerns of the System to social or political protests. At the same time, the System expects the companies in which it acquires stock to be solid corporate citizens that abide by federal, state, and local laws. The Board has adopted the following position on corporate behavior:

The Board's stated fiduciary duty is to obtain the highest return for the Fund commensurate with acceptable levels of risk. This implies that non-financial considerations cannot take precedence to pure risk/return considerations in the evaluation of investment decisions. However, action taken by the Fund as a shareowner can be instrumental in encouraging action as a responsible corporate citizen by the companies in which the Fund has invested.

The Board expects the managements of the companies whose equity securities are held in the Fund's portfolio to conduct themselves with propriety and with a view toward social considerations. A level of performance above minimum adherence to the law is generally expected. If any improper practices come into being, the Board expects corporate management to move decisively to eliminate them and effect adequate controls to prevent recurrence.

On the other hand, the Board does not intend to supplant the duties which are the responsibility of federal or state regulatory agencies, such as the Equal Employment Opportunity Commission, the Environmental Protection Agency, the Occupational Safety and Health Agency, the Nuclear Regulatory Commission, the Securities and Exchange Commission, and others which are covered by the laws of the United States Government or the State of Kentucky.

Should satisfaction of the Board's criteria by any company not be adequate, the Board will consider what action to take, which may include, but not be limited to, correspondence with the company, meetings with company officials, sponsoring of shareholder resolutions or, as a last resort, liquidation of the System's holdings in the company, if the sale is consistent with sound investment policy.

## SECURITY LENDING

The System operates a security lending program in which it temporarily lends securities to qualified agents in exchange for a net fee and high quality collateral. U.S. Government and agency securities and selected domestic stocks and bonds are the types of securities lent. The System's sub-custodian, The Bank of New York Mellon, acts as ending agent in exchanging securities for collateral. The collateral, at the time of the loan, has a value of not less than 102% of the market value of the lent securities plus any accrued, unpaid distributions. The collateral consists of cash, marketable U.S. Government securities, and selected marketable U.S. Government agency securities approved by the System.

Cash collateral is invested in short term obligations fully guaranteed by the United States Government or select Government agencies and Government Repurchase Agreements with qualified agents. The System cannot pledge or sell collateral securities unless the borrower defaults. The lending agent also indemnifies the System from any financial loss associated with a borrower's default and collateral inadequacy. The weighted average maturity of cash collateral investments is typically two days. The System has no credit risk exposure to borrowers, since the amounts the System owes borrowers exceeds the amounts the borrowers owe the System.

Security lending programs can entail considerable interest rate risk and credit risk. The System has structured its program to minimize these two main categories of risk. The interest rate risk is managed, as mentioned above, by limiting the term of cash collateral investments to several days. The credit risk is controlled by investing cash collateral in securities with qualities similar to the creditworthiness of lent securities.

### KENTUCKY INVESTMENTS

The System is ever mindful of its impact on the Commonwealth's economy. For the fiscal year ended June 30, 2008, approximately \$1.3 billion in defined benefit pension payments were distributed to annuitants living in Kentucky. Approximately \$330 million of the System's investments directly impact the Commonwealth. These investments include: pools of single-family mortgages in Kentucky; financing for multi-family housing; bonds issued by public agencies of the Commonwealth and those of local municipalities; direct ownership of commercial real estate, and; investments in the bonds of Kentucky-based corporations. This excludes hundreds of millions in equity investments in companies which have an impact on the Commonwealth's economy but receive earnings from world-wide operations. Fiduciary duty requires that investments be made solely for the benefit of the System's members and annuitants. Investments which benefit the Commonwealth's economy are made only when fully consistent with this fiduciary duty.

### PROFESSIONAL SERVICE PROVIDERS

**Investment Consultants**

Becker, Burke Associates, Inc.  
Ennis Knupp + Associates

**Investment Custodian/Subcustodian**

Farmers Bank and Capital Trust Co.  
The Bank of New York Mellon

**Fixed Income Managers**

Galliard Capital Management  
Ft. Washington Investment Advisors

**Domestic Equity Managers**

Todd Investment Advisors  
UBS Global Asset Management  
Wellington Management Company  
GE Asset Management

**International Equity Managers**

Todd Investment Advisors  
UBS Global Asset Management  
Baring Asset Management, Inc.  
Baillie Gifford

**Real Estate Managers**

Prudential Real Estate Investors

**Private Equity/Venture Capital Managers**

Kohlberg Kravis Roberts & Co.  
Chrysalis Ventures  
Fort Washington Private Equity Investors

**Timberland Managers**

Molpus Woodlands Group  
Hancock Natural Resources Group

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